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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Simplification of the Depreciation Prescription Process	)	CC Docket No. 92-296
	)	
	)	

TO: The Commission

COMMENTS

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March 10, 1993

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SUMMARY

In its *Notice*, the Commission proposes to simplify the depreciation prescription process which is currently applied to U S WEST and numerous other carriers. U S WEST strongly supports this initiative and urges the Commission to adopt its "Price Cap Carrier" option for carriers subject to price cap regulation. U S WEST believes that this approach would provide sufficient flexibility for carriers to modify their depreciation rates to more accurately reflect today's telecommunications environment with little or no impact on ratepayers.

Under the Commission's price cap plan, depreciation is an endogenous cost. Changes in depreciation rates and lives are no longer translated into rate changes. The fact that LEC price cap regulation contains one last vestige of rate of return regulation -- in the form of sharing and the low-end adjustment -- should not deter the Commission from revising its depreciation process to reflect market conditions. The merits of adopting realistic depreciation rates far exceed any benefits associated with artificially holding down depreciation expense to avoid possible impacts on LEC sharing amounts. The Commission should not allow its depreciation determinations to be influenced by "sharing arguments" and should adopt the Price Cap Carrier option at the earliest possible date.

The "Basic Factors Range" and "Depreciation Rate Range" options, while not the most desirable, are second best alternatives. Both options, if reasonably implemented, would

allow carriers to employ depreciation rates which more accurately reflect their individual experience. If the Commission does elect to use either of these options, it should: develop ranges from carriers' proposed service lives rather than from historical data; apply the ranges to all plan accounts; and allow for a transition period.

The "Depreciation Schedule" option is the least desirable option and should not be adopted by the Commission. This option allows for no flexibility between carriers to reflect individual characteristics or different business environments. Under this option, every carrier's depreciation rates will be the same for the investment in each account by year. The Depreciation Schedule option assumes a uniformity among carriers that never existed in the past -- and is even less likely to exist in the future.

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COMMENTS

U S WEST Communications, Inc. ("U S WEST"),[1] through counsel and pursuant to the Federal Communications Commission's ("Commission") Notice of Proposed Rulemaking ("Notice" or "NPRM") in the above-captioned docket, hereby files its comments on the Commission's depreciation proposals.[2]

I. INTRODUCTION

In its Notice, the Commission proposes to simplify the depreciation prescription process which is currently applied to American Telephone and Telegraph Company ("AT&T"), Alascom Inc. ("ALASCOM"), and 33 local exchange carriers ("LEC"), including U S WEST.[3] The Commission's power to prescribe depreciation rates emanates from Section 220(b) of the Communications Act.[4]

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[1] U S WEST is a common carrier provider of exchange access and exchange telecommunications services.

[2] See Simplification of the Depreciation Prescription Process, 8 FCC Rcd. 146 (1992).

[3] See id. at 146-47 ¶ 2.

[4] See 47 U.S.C. § 220(b).

Under this Section of the Act, the Commission may classify carriers "as it may deem proper" and prescribe "the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property."[5]

In implementing this legislative directive, the Commission has adopted detailed depreciation rules.[6] As the Commission notes, its depreciation process was "refined over a period in which the Commission regulated telephone earnings on a rate of return/rate base basis."[7] As such, the Commission's primary objective has been to ensure that depreciation rates did not result in "unreasonable" rates to ratepayers.[8] The objective of ensuring that depreciation rates adequately reflected the economic lives of plant and equipment has always been secondary. Even when the Commission recognized the inadequacy of past depreciation rates through depreciation reserve deficiency amortizations (or "RDA"), it was still reluctant to prescribe forward-looking depreciation rates which reflected the true economic lives of

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[5] Id.

[6] See 47 C.F.R. § 43.43.

[7] Notice, 8 FCC Rcd. at 147 ¶ 7 (footnote omitted).

[8] Id. at 147-48 ¶¶ 7-8. The Commission correctly notes that under rate base/rate of return regulation, changes in depreciation expense are reflected in rates paid by customers. See id. at 147 n.7.

plant.[9] While the Commission's past depreciation practices may have been justified in a rate base/rate of return environment with a single service provider, they clearly are not now. The telecommunications environment has changed dramatically with the introduction of price cap regulation and the growth of competition.

Under the Commission's price cap plan, depreciation is an endogenous cost.[10] Changes in depreciation rates and lives are no longer translated into rate changes. Without off-setting productivity gains, increases in depreciation rates result in lower earnings for price cap carriers, not higher prices. Thus, while price cap carriers have a desire to ensure that their depreciation rates reflect economic reality, they do not have an

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[9] See, e.g., Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers, 3 FCC Rcd. 984 (1988) ("RDA Order). The existence of industry-wide reserve imbalances (i.e., depreciation reserve deficiencies) demonstrates that current depreciation rates and service lives are not representative of economic lives. A reserve deficiency exists when a carrier's actual "book" depreciation reserve is less than its "theoretical" reserve. The theoretical reserve is the reserve which would have existed if forecasted service lives and salvage values were an accurate representation of actual experience. The fact that current reserve deficiencies have grown to their present levels in the short time since January 1, 1987, is further evidence of the inadequacy of current depreciation rates.

[10] See Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, 6809 ¶ 182 (1990) ("Price Cap Order"), on recon., 6 FCC Rcd. 2637, 2671-72 ¶¶ 73-74 (1991) ("Price Cap Recon. Order"), appeals pending sub nom. NRTA v. F.C.C., No. 91-1300 (D.C. Cir. pet. for rev. filed June 26, 1991).

incentive to advocate or employ depreciation rates that are too high or lives that are too short.[11]

The fact that LEC price cap regulation contains one last vestige of rate of return regulation -- in the form of sharing and the low-end adjustment -- should not deter the Commission from revising its depreciation process to reflect market conditions.[12] While it is true that depreciation rate changes could have an impact on LEC sharing amounts in any given year, it is also true that no more than 100% of the original cost of an asset may be depreciated and that the depreciation reserve deficiency problem will be exacerbated if depreciation rates are not adjusted upward. The merits of adopting realistic depreciation rates far exceed any benefits associated with holding down depreciation rates to avoid possible impacts on LEC sharing amounts.[13] As such, the Commission should not allow its depreciation

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[11]It must also be remembered that a company cannot depreciate more than 100% of an asset. Over depreciation during earlier periods leads to lower depreciation during later years. While it is a "zero sum game," timing is critical. Generally Accepted Accounting Principles ("GAAP") require that capital costs (i.e., depreciation) be allocated to different time periods to match future expected revenue streams (i.e., the matching principle).

[12]Critics that claim LECs will game the process fail to recognize that carriers do not select depreciation rates or lives on the basis of any given year's performance. Furthermore, GAAP principles and financial reporting requirements (e.g., Securities and Exchange Commission) require carriers to use "disciplined" depreciation processes.

[13]Sharing was never intended to have any impact on legitimate business expenses such as depreciation. The Commission adopted sharing as a "backstop" to protect against variations in productivity for individual LECs. See Price Cap Order, 5 FCC Rcd. at 6801 ¶¶ 120-21.

determinations to be influenced by "sharing arguments." To do so would be the equivalent of allowing "the tail to wag the dog."

Competition has also had a dramatic effect on the equipment lives of large LECs and interexchange carriers ("IXC").[14] Technological advances and competition go hand in hand and tend to enhance each other. Even before carriers faced competition of any significance, technological gains and competition in the computer industry had a major effect on service lives of telephone assets. With increased competition in all sectors of the telecommunications industry, and more to come with expanded interconnection, the impact on depreciation rates and service lives cannot be ignored.[15] Thus, the Commission should take this opportunity to update its depreciation rules to reflect today's telecommunications environment, in addition to simplifying its rules to reduce administrative burdens on all parties.

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[14]Even companies such as MCI Telecommunications Corporation ("MCI"), which are not subject to the Commission's depreciation procedures, are not always able to anticipate the effects of competition on service lives. For example, in 1990 MCI took a pretax charge of $550 million to recognize the permanent impairment in the value of analog equipment caused by the acceleration of the company's move to a fully-digital communications network. See MCI 1991 Annual Report at 41.

[15]AT&T highlights this fact in its Petition for Waiver when it points out that there is a $4 billion difference between its MR and FR depreciation reserve. See American Telephone and Telegraph Company, Petition for Waiver of the Commission's Depreciation Methods and Procedures, filed Jan. 27, 1993, at 12-15.

II. U S WEST'S POSITION

Given the preceding comments, it should come as no surprise that U S WEST favors the "Price Cap Carrier" option. Under this option, carriers would file the following information with the Commission: depreciation rates in effect; proposed depreciation rates; and changes in depreciation expense associated with the proposed rates.[16] This information would then be subject to public comment -- including comment from state commissions -- and the Commission would prescribe depreciation rates.[17] U S WEST believes that this approach would provide sufficient flexibility for carriers to modify their depreciation rates to more accurately reflect today's telecommunications environment with little or no impact on ratepayers. This option has great appeal because of its simplicity. Today's depreciation process, while very precise -- is not accurate. Depreciation rates do not reflect the economic lives of different types of assets -- they reflect the results of past regulatory compromises. The detail and precision of the current depreciation process does no more than obscure the fact that current rates are inappropriate.

With the introduction of price cap regulation, there is no justification for continued use of the current "artificial" depreciation process for price cap carriers. In fact, the current depreciation process, with its inadequate rates, exacerbates the

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[16]Notice, 8 FCC Rcd. at 152 ¶ 41.

[17]Id.

existing depreciation reserve deficiency problem. It makes no sense for the Commission to continue to prescribe depreciation rates for price cap carriers which lead to increases in the depreciation reserve deficiency when higher depreciation rates would not burden ratepayers.[18] As such, U S WEST strongly endorses the Commission's "Price Cap Carrier" option and requests that the Commission adopt it at the earliest possible date.[19]

III. THE COMMUNICATIONS ACT IS NOT AN IMPEDIMENT TO ADOPTING THE "PRICE CAP CARRIER" OPTION

The Commission requests comment on whether the "Price Cap Carrier" option is consistent with the Commission's statutory obligations under Sections 220(b) and 220(i) of the Act.[20] Under Section 220(b), the Commission is required to:

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[18]U S WEST's depreciation reserve deficiency of approximately $900 million (i.e., at current prescribed lives) is largely the result of past regulatory decisions. The establishment of forward-looking depreciation rates which reflect economic reality will not solve the depreciation reserve deficiency problem but should ensure that it will not worsen. In fact, U S WEST believes that adoption of the Commission's "Price Cap Carrier" option would allow carriers sufficient latitude to establish depreciation rates which would offset past inadequacies. This could assist price cap carriers in resolving their depreciation reserve deficiency problems without creating a separate amortization (i.e., Reserve Deficiency Amortization). Otherwise, the Commission might find it necessary to establish an RDA -- which could lead to impacts on ratepayers as a result of exogenous treatment under current price cap rules.

[19]In addition to allowing carriers to more appropriately align depreciation rates with the economic lives of assets, adoption of this option would significantly reduce the administrative burden on both the Commission and price cap carriers.

[20]Notice, 8 FCC Rcd. at 152-53 ¶¶ 41-42.

> prescribe . . . the classes of property for which depreciation charges may be properly included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed.[21]

Section 220(b) does not dictate any methodology for prescribing depreciation rates. The Commission is given the freedom to adopt rules as it sees fit to implement this Section of the Act. The Commission may establish different classes of property and carriers for depreciation purposes and has done so.[22] U S WEST believes that the Commission can single out price cap carriers as a separate class for depreciation purposes. This is a reasonable classification and nothing in Section 220(b) would prohibit it.

Similarly, this Section of the Act gives the Commission latitude to prescribe classes of property and depreciation rates as it finds necessary. Section 220(b) also allows the Commission to modify carrier classes, property classes, and depreciation rates as it deems necessary. Thus, the Commission is in no way

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[21] 47 U.S.C. § 220(b).

[22] See 47 C.F.R. § 43.43. U S WEST is perplexed by the Commission's concern as to whether the "Price Cap Carrier" option and other options comply with Section 220(b) of the Act. The Commission's current depreciation rules exempt virtually all IXCs, except for AT&T, and all small LECs (i.e., less than $100 million in annual operating revenues). See id. at § 43.43(a). Consequently, most LECs and IXCs, including multi-billion dollar carriers, are not subject to the Commission's depreciation requirements. If anything, the Commission's exemption of these carriers raises more questions with respect to the application of Section 220(b) of the Act than the adoption of any of the options delineated in the NPRM.

obligated to continue using its current depreciation process. Rather than being an obstacle to the adoption of the "Price Cap Carrier" option, Section 220(b) explicitly allows the Commission to employ this option.

Section 220(i) requires that state commissions be notified and given an opportunity for comment before the Commission prescribes depreciation rates.[23] This Section says nothing about three-way meetings. The Commission is given the prerogative to determine how it will satisfy this statutory mandate. U S WEST believes that the Commission's proposed notice and comment process[24] easily satisfies the requirements of Section 220(i).

IV. THE "BASIC FACTORS RANGE" AND THE "DEPRECIATION RATE RANGE" ARE SECOND BEST OPTIONS

The "Basic Factors Range" and "Depreciation Rate Range" options, while not the most desirable, are second best alternatives. Both options, if reasonably implemented, would allow carriers to employ depreciation rates which more accurately reflect actual service lives of individual carriers. Of the two options, U S WEST prefers the Depreciation Rate Range option. As the

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[23] 47 U.S.C. § 220(i). U S WEST's comments in this section are directed at statutory requirements under Section 220(i) of the Act, not at U S WEST's willingness to work with state regulatory commissions. U S WEST has and will continue to work closely with state commissions to assist them in resolving depreciation and capital recovery issues, including providing any necessary data.

[24] Notice, 8 FCC Rcd. at 152 ¶ 41.

Commission points out in its NPRM, this option frees carriers from using the Commission's existing depreciation formula and allows carriers greater flexibility in selecting depreciation methods and factors.[25]

Both the Depreciation Rate Range and Basic Factors Range options suffer from some of the same defects. The Commission proposes to use industry-wide data in establishing both ranges. While this approach has merit, it is unlikely that the Commission will establish range limits which are representative of the experience of all carriers. "Outliers" will suffer under these options -- but not nearly so much as they would under the Depreciation Schedule option. Also, it is likely that in establishing ranges the Commission will give greater weight to historical experience than to future projections of service lives. Therefore, if the Commission does elect to use one of these two options, U S WEST urges the Commission to develop ranges from carriers' proposed lives rather than from historical data.

Another concern with both options is that the Commission has tentatively concluded that it should not apply either the Basic Factors or Depreciation Rate Range to all plant accounts.[26] The Commission seeks comment on the criteria that it should use in selecting plant accounts.[27] U S WEST strongly urges the Commission to apply either option, if selected, to all plant accounts.

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[25] Id. at 150 ¶ 26.

[26] Id. at 148-50 ¶ 16, 150-51 ¶ 28.

[27] Id.

The benefits of both options could vary widely depending upon which accounts are selected for inclusion. Establishing selection criteria and going through the process of determining which accounts meet these criteria just creates another regulatory hurdle and serves no useful purpose. Many resources will be expended by all participants in this effort, and the costs will far exceed any incremental benefit associated with applying these options to selected accounts. If the Commission selects either option, it should be applied across-the-board to all plant accounts.

One other issue of concern to carriers if the Commission selects either option is that of transition -- "how does a carrier get from here to there?" It is difficult to say much about the transition period necessary to move to a new depreciation method -- other than there needs to be one. For any given carrier, the difficulty or ease of the transition will vary with the ranges which the Commission prescribes. The only thing that can be stated with certainty is that some carriers will need a transition period to move to the new ranges in order to avoid unnecessarily disruptive financial impacts. U S WEST recommends that the Commission allow carriers a period of three to five years, if necessary, to transition to new depreciation rates under either option. If carriers are comfortable in moving immediately to the new rates, they should be allowed to do so.

V. THE "DEPRECIATION SCHEDULE" OPTION IS THE LEAST DESIRABLE OPTION

Under the Depreciation Schedule option, "the Commission would establish a depreciation schedule based on a Commission-specified average service life, retirement pattern and salvage value for each applicable plant account."[28] In all likelihood, the depreciation schedule would be created using industry averages or averages of industry projections. Carriers would then apply the schedule to each account by vintage.[29]

This option allows for no flexibility between companies to reflect individual characteristics or different business environments. For better or for worse, every carrier's depreciation rates will be the same for the investment in each account by year -- reflecting some amorphous "industry average." The total lack of flexibility of this option more than outweighs any benefits associated with the "certainty" of depreciation expense. "Certainty" does not help if depreciation rates do not accurately reflect the experience of individual companies. This option implicitly assumes that all carriers will: face the same level of competition; deploy technology in the same manner; use plant in the same manner; experience the same service lives; and so on. This option assumes a uniformity among carriers that never existed in the past -- and is even less likely to exist in the future. As such, U S WEST urges the Commission to delete this

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[28] Notice, 8 FCC Rcd. at 151 ¶ 33.

[29] Id.

option from those being considered. While adoption of this option might simplify depreciation procedures, in all likelihood it would exacerbate existing reserve deficiency problems and lead to the use of inappropriate depreciation rates for most companies.

VI. THE DEPRECIATION RESERVE DEFICIENCY PROBLEM WILL NEED TO BE ADDRESSED IF THE COMMISSION ADOPTS EITHER THE "BASIC FACTORS RANGE," "DEPRECIATION RATE RANGE," OR "DEPRECIATION SCHEDULE" OPTION

The Commission's first three options -- the "Basic Factors Range," "Depreciation Rate Range," and "Depreciation Schedule" -- do not provide carriers with sufficient latitude to resolve their reserve deficiency problems within a reasonable period of time. The only way to resolve this problem is for the Commission to prescribe a Reserve Deficiency Amortization in addition to prescribing new depreciation rates under either of the first three options.[30] Otherwise, there will continue to be a mismatch between revenue streams and depreciation expense -- at a time when the Commission is trying to encourage infrastructure investment. The Commission has recognized in its most recent RDA Order that it is in the public interest to act expeditiously in resolving industry-wide reserve deficiencies.[31] As such, U S WEST urges the Commission to prescribe an appropriate RDA if it selects one of its first three options.

[30] The Commission's "Price Cap Carrier" option becomes even more appealing from a public interest standpoint when one considers that an RDA would qualify for exogenous cost treatment under the Commission's price cap rules.

[31] See RDA Order, 3 FCC Rcd. at 986-88 ¶¶ 17-23.

VII. CONCLUSION

For the foregoing reasons, U S WEST recommends that the Commission adopt its "Price Cap Carrier" option for prescribing depreciation rates for price cap carriers. This option would allow price cap carriers to employ depreciation rates which reflect economic reality with little or no impact on ratepayers. It would also provide carriers with sufficient latitude to resolve their reserve deficiency problems over a reasonable period of time without an RDA.

Respectfully submitted,

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March 10, 1993

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify on this 10th day of March, 1993, that I have caused a copy of the foregoing **COMMENTS** to be hand delivered to the persons named on the attached service list.

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